DEPARTMENT OF STATE REVENUE

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Supplemental Letter of Findings: 01-20200367; 01-20200368; 01-20200369; 01-20200370; 01-20200371; 01-20200372; 01-20200373; 01-20200374; 01-20200375
Indiana Individual Income Tax
For the Years 2015 and 2016

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HOLDING

On rehearing, the Department continued to disagree with Indiana Shareholders that they met their burden of establishing that their Brewery provided the specific, contemporaneous documentation sufficient to establish that Shareholders were entitled to the flow-through qualifying research expense credits attributable to the Brewery's development and manufacture of new beer flavors and beer formulations.

ISSUE

I. Indiana Individual Income Tax - Qualified Research Expense Projects and Supporting Documentation.

Authority: IC § 6-3.1-4-1; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *New Colonial Ice Co. v. Helvering*, 292 US. 435 (1934); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Indiana Dep't of State Rev. v. Caterpillar, Inc*., 15 N.E.3d 579 (Ind. 2014); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Erdmannsdorff v. Indiana Dept. of State Revenue,* 53 N.E.3d 621 (Ind. Tax Ct. 2016); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin*., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); I.R.C. § 41; I.R.C. § 6001; Treas. Reg. § 1.41-4; Treas. Reg. § 1.174-2; Treas. Reg. § 1.6001-1.

Taxpayers argue that their brewing company conducted qualified, experimental research activities, that they can adequately document the wage, supply, and contract expenses related to those projects, and that they are therefore entitled to claim the benefit of the flow-through credits associated with their company's qualifying research activities.

STATEMENT OF FACTS

Taxpayers are individual owners/partners of an Indiana brewery ("Brewery") which develops, brews, bottles, and sells various craft beers. The Brewery is organized as a partnership and files form IT-65 Indiana partnership income tax returns. The Brewery's income and losses pass through to its partners who, in turn, report the income and losses on their individual income tax returns.

The Indiana Department of Revenue ("Department") conducted an audit review of the Brewery's 2015 and 2016 Indiana partnership income tax returns. Except for issues related to research expense credits ("RECs"), the audit found that the Brewery's "Indiana adjusted gross income, including Indiana modifications, were materially correct as [originally] filed."

The audit found that the Brewery claimed Indiana RECs during 2015 and 2016. The Brewery indicated that the RECs were based on the results contained within an REC study prepared by a third-party consultant ("Consultant").

After reviewing the REC study and the claimed credits, the Department concluded that the Brewery failed to

establish that the Brewery's development and manufacturing activities constituted "qualified research" and that the Brewery failed to establish that the labor expenses - on which credits were largely based - directly related to the claimed qualifying activities. In reviewing the labor expenses, the Department concluded that the Brewery's "time tracking" records did not represent the actual amount of time spent by the Brewery employees on qualified research activities and could not be used to factually support the Qualified Research Expenses ("QREs") claimed.

The audit also found that the Brewery failed to establish that it was entitled to claim RECs based on the cost of supplies consumed during the course of the Brewery's activities. The audit concluded that the claimed supply expenses "could not be substantiated . . . ."

The Department's audit's decision disallowing the credit did not result in the assessment of additional income tax for the Brewery because the Brewery was organized as a partnership. As the audit report notes, the Brewery's "research credits are passed through to the partners . . . responsible for reporting the partnership income and credits on their individual income tax returns." As a result of the Brewery audit, Taxpayers were assessed additional individual income tax. Taxpayers disagreed with the assessments and each submitted a protest to that effect. An administrative hearing was conducted on April 6, 2020 during which Taxpayers' representatives explained the basis for the protest. A Letter of Findings was issued on July 23, 2020. The July 2020 LOF was docketed as 01-20200017; 01-20200018; 01-20200019; 01-20200020; 01-20200021; 01-20200022; 01-20200023; 01-20200024; 01-20200025. In each case, Taxpayers' protests were denied.

Taxpayers' representative petitioned for an administrative rehearing in a letter dated August 20, 2020, objecting to the LOFs' conclusion and arguing that they were then prepared to provide information that would substantiate the amount of credits claimed. The rehearing request was granted in a letter dated September 10, 2020. The rehearing was granted with the understanding that Taxpayers were then-and-there prepared to substantiate their claim to the RECs at issue.

The rehearing was conducted by teleconference on October 5, 2020 and was attended by Taxpayers' representatives, the Hearing Officer, and two members of the Department's audit division. This Supplemental Letter of Findings was prepared in response to the rehearing request and to any additional documentation provided.

As a matter of efficiency, and since each individual protest is identical, this document will respond to all protests submitted by Taxpayers.

I. Indiana Individual Income Tax - Qualified Research Expense Projects and Supporting Documentation.

DISCUSSION

A. The July 2020 Letter of Findings and the Issues Addressed in this Supplemental Letter of Finding.

The July 2020 LOF denied the protest based on the confluence of two different issues; the first was whether Taxpayers were able to clearly define the nature and extent of the research and experimentation activities fundamental to any claim to the credits. The second issue was whether Taxpayers were able to document the extent and cost of those qualifying activities; what precise amount of activities were clearly documented? Did the Brewery spend $200 conducting qualifying research, did it spend $2,000,000 conducting that research, or did it spend an amount somewhere in between those extremes?

As to the nature of the Brewery's activities, the LOF acknowledged that "the Department may intuitively agree that the Brewery likely conducted qualifying research." Later in the decision, the Department again indicated that that it would "not dismiss the possibility that activities associated with development and formulation of wholly new [beer] brands" would qualify for the credit. However, the Department found itself "unable to agree that there is sufficient quantifiable and verifiable information to allow the credits in the amount requested and as here protested."

As to the second question, the Department found that the Taxpayers' basis for calculating the credit was fundamentally unsound. The LOF found that Taxpayers' claim to the credit - a strictly numerical calculation - was based entirely on estimates of the amount of time Taxpayers' employees were engaged in qualifying research activity. In turn, those estimates were based on employee interviews conducted subsequent to the time those employees were engaged in the activity cited.

Gallons of ink and hours of time have been expended by both Taxpayers and the Department in addressing both these issues. For purposes of this Supplemental Letter of Finding, the Department will set aside well-trodden

issues of "uncertainty" and "discovery." The Department will not address questions of whether or not developing a seasonal beer formulation is "technological." The Department here will not delve into the significance or applicability of the various court decisions on which Taxpayers rely. Instead, the simple issue here is whether the Taxpayers have now brought to the table additional documentation sufficient to tick-and-tie purportedly qualifying activities to the labor expenses associated with employees conducting those qualifying activities.

In the world of tax analysis, this documentation question is fundamental to almost any disputed issue. In this situation, Taxpayers claim that its Brewery spent exactly $1,123,507.00 conducting qualifying research activities; very well, how did the Taxpayers arrive at that number?

B. Burden of Proof.

Tax assessments are *prima facie* evidence that the Department's assessment of tax is presumed correct; in every assessment case, each taxpayer bears the burden of proving that the assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin*., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Also, "[A]ll statutes are presumptively constitutional." *Indiana Dep't of State Rev. v. Caterpillar, Inc*., 15 N.E.3d 579, 587 (Ind. 2014). When an agency is charged with enforcing a statute, the jurisprudence defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Id.* at 583.

IC § 6-3.1-4-1 provides that, "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3." Similar to deductions, exemptions, and exclusions, tax credits - such as RECs - "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000).

Every taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. Indiana and federal law require that a taxpayer maintain and produce contemporaneous records sufficient to verify those credits. *See* Treas. Reg. § 1.41-4(d). (*See also* IC § 6-8.1-5-4(a) which requires that taxpayers *keep* records). Where such a credit is claimed "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)).

Citing *Stinson Estate*, the circuit court in *United States v. McFerrin* summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009). See also *New Colonial Ice Co. v. Helvering*, 292 US. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.")

C. The Department's Audit Threshold Conclusions.

I.R.C. § 41(d) sets out a four-pronged test for verifying qualified research activities. First, the research must have qualified as a business deduction under I.R.C. § 174. I.R.C. § 41(d)(1)(A). Second, the research must be undertaken to discover information "which is technological in nature." I.R.C. § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business component. I.R.C. § 41(d)(1)(B)(ii). Finally, the taxpayer must pursue a "process of experimentation" during substantially all of the research. I.R.C. § 41(d)(1)(C). All four tests must be satisfied in order to qualify for the credit.

In a point-by-point analysis, the Department's audit considered whether the Brewery's activities met each of the four-part tests set out in I.R.C. § 41. In considering first the "business deduction" test, the Department's audit report cited to Treas. Reg. § 1.174-2(a) in concluding that Taxpayers' employees had the experience to undertake the resolution of any uncertainty involved in the development of new beer or beer ingredients and that any "uncertainties" involved could have been resolved by a routine adaption of existing brewing techniques.

The report concluded that Taxpayers' cited activities did not meet the "discovering technological information" test required under Treas. Reg. § 1.41-4(a)(3)(i) because the Brewery activities "were not qualified research under either the 'Discovery' or 'Uncertainty' versions of the regulation, (TD 8930 or TD 9104)." However, the audit report also noted that only "new ingredients would qualify for the research and development expense credits [and that] ingredients used in the beer process every time would not qualify."

The Department's report concluded that the Brewery failed the "new or improved business component" test citing to guidance published by the IRS. The report concluded that "Brewery failed to establish that it met the third qualifying test because there was no evidence that Brewery 'intend[ed] to use the information to develop a new or improved business component.'" In this case, the audit found that Taxpayers did not have "specific information about [] projects and employees" and that Taxpayers were unable to supply a "breakdown of the QRE wages by project . . ." as required by the federal guidelines.

In considering the fourth test, the audit relied on Treas. Reg. § 1.41-4(a)(5) (TD 8930) and Treas. Reg. § 1.41-4 (TD 9104) in concluding that Taxpayers did not meet the "undertaking a process of experimentation" component because Taxpayers failed to establish that substantially all (i.e., 80[percent] or more) of its activities related to a process of experimentation for each business component. As explained in Treas. Reg. § 1.41-4 (TD 9104), "[T]he mere existence of uncertainty regarding the development or improvement of a business component does not indicate that all of a taxpayer's activities undertaken to achieve that new or improved business component constitute a process of experimentation . . . ." Repeatedly reciting that Brewery undertook an "iterative" process in developing its beers and beer formulations was "not sufficient to show a process of experimentation."

As to the qualified activities themselves, the Department found that Taxpayer failed to establish that the Brewery's development of new beer flavors and new beer formulations necessarily constituted qualifying activities under I.R.C. § 41(d).

D. Documenting the Amount of Credits Originally Claimed.

The Department's audit, Taxpayers' protest, the original Letter of Findings, the request for rehearing, the rehearing itself, and this Supplemental Letter of Findings are all centered around basic tax issues. The amount of expenses at issue is $1,123,507 and the amount of credits at issue is $84,263. Even if it is a given that Brewery is engaged in qualifying research activities, the issue here is whether those numbers are correct. Can Taxpayers establish with any certainty that the amount of expenses and the amount of credits claimed is correct?

The Department's audit found that Taxpayers failed to meet that fundamental question. Without unnecessarily repeating the audit's analysis, the conclusion was that "[Brewery] does not maintain the type of information or documentation set forth in this question in its normal course of business." Specifically, the audit report cited I.R.C. § 6001 and Treas. Reg. § 1.6001-1 for the proposition that an REC claimant "must have contemporaneous documentation that was prepared before or in the early stages of research project that describes the principal questions to be answered and the information the [claimant] seeks to obtain."

The July LOF agreed with the audit's conclusion; finding as follows:

> Taxpayers essentially seek a form of "summary judgment" in which the Department administratively overturns the audit's finding that "the [Brewery] has not provided records to substantiate the amounts of the credits reported on its returns" and has not provided "contemporaneous documentation . . . to support the employee research participation percentages that [Brewery] used to calculate the qualified research expenses." Although the Department may intuitively agree that the Brewery likely conducted qualifying research, the Department is unable to agree that there is sufficient quantifiable and verifiable information to allow the credits in the amount requested and as here protested.

In their rehearing request, Taxpayers object arguing that the Department has imposed a "rigid and specific substantiation requirement[] for research credits" not supported in "Federal research credit or Indiana Tax Court jurisprudence." According to Taxpayers, the only record keeping requirements are found in I.R.C. § 6001-1(a) which provides:

> Any person required to file a return of information with respect to income shall keep such permanent books of accounts or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in any return of such tax or information.

Taxpayers explain what actions Brewery's employees undertook to document their research activities.

> To substantiate its qualified wage expense . . . Taxpayer began by considering each of its employees and their roles in the company. For those seemed likely to perform qualified services, the details of their work were further explored by undertaking to identify all the tasks those employees perform and estimating how much of their time is spent doing each of those tasks. . . . Thereafter, the portions of time devoted to those

> tasks the U.S. Tax Court has held constitute qualified research were compiled to arrive at an allocation percentage used to calculate the qualified wage expenses attributable to each employee.

Moreover, Taxpayers explained that they were well prepared "to prove up each allocation through the testimony of a few employees."

In its rehearing request, Taxpayers stated that they were now ready to offer up "contemporaneous documentary substantiation that would satisfy even the requirements to T.D. 8930."

In addition, Taxpayers explain that its newly provided documentation more than meets the *Erdmannsdorff* standard promulgated by the Indiana Tax Court in *Erdmannsdorff v. Indiana Dept. of State Revenue,* 53 N.E.3d 621 (Ind. Tax Ct. 2016). In that case, the court found that the petitioner sufficiently established the true extent of its tax liability and was entitled to summary judgment by virtue of the petitioner's own "after-the-fact reconstructed inventories and credit card statements." *Id.* at 624-25. The Department does not agree that the *Erdmannsdorff* decision is dispositive. In *Erdmannsdorff* the petitioner presented the court with tangible, measurable - although disputed - evidence supporting its store inventory.

In Taxpayers' case they correctly label their documentation as estimates and reconstructions neither of which necessarily meet the documentation standard required to qualify for the credit. As with any tax matter, there must be something tangible and measurable at the core of any claim to a credit or expense whether that be a withholding return, receipt, pay stub, timesheet, or the like. Taxpayers rest their claim on employee activities which took place during 2015 and 2016 which relied on employee interviews and "statistical sampling plans." Taxpayers' stake their claim based on activities performed by its "production" personnel, persons involved in "sales marketing," a person working in the "front office" because that person provides "technical and engineering expertise," and persons involved in the "maintenance" of the Brewery facility on the ground that these maintenance personnel contribute to the "implementation of process improvements . . . ."

The Department does not deny the very real possibility that some or all these employees may have engaged in qualifying research and experimentation some six or seven years ago. However, Taxpayer is not merely asking that the Department agree with that "possibility" premise. Instead, it asks the Department to simply agree that it paid $1,123,507 to perform those specific qualifying activities. The Department reminds Taxpayers of its long-held position on the documentation issue:

> Indiana case law speaks clearly and plainly to the issue of the documentation required to establish one's entitlement to credits such as that sought by Taxpayers. "[A]n income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992). Moreover, where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the **exact letter of the law**." *RCA Corp.*, 310 N.E.2d at 100-01. (**Emphasis added**). Thus, every taxpayer's claims against any tax must be supported by records necessary to substantiate the claimed credits and those records are required to be "kept" "before or during the early stages of the research project."

Following the rehearing, the Department expressed its willingness to devote the time and energy of two experienced auditors to once more review Taxpayers' documentation and to reconsider or adjust the pending assessment provided that Taxpayers prepare a specific sampling of that documentation sufficient to warrant undertaking a fresh review of everything Taxpayer was prepared to present. Some two months later, Taxpayers have so far failed to follow through with that request.

The Department finds that Taxpayers have not met their statutory burden under IC § 6-8.1-5-1(c) of establishing that the assessments were "wrong." The Department finds that Taxpayers have not "clearly" established that they spent $1,123,507 during 2015 and 2016 in conducting qualifying research.

FINDING

Taxpayers' protest is respectfully denied.

June 18, 2021

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